Exemptions from FMV Determination - Expand the exemption provisions provided in paragraph 148 of the Accounting Safeguards Order. In paragraph 148, the Commission granted relief from the FMV requirements, allowing that affiliate service "transactions where a carrier purchases from its affiliate services that are neither tariffed nor subject to prevailing company prices and such affiliate exists solely to provide services to members of the carrier's corporate family should continue to be valued at fully distributed cost. We find that when an affiliate is established to provide services solely to the carrier's corporate family in an effort to take advantage of economies of scale and scope, the benefits of such economies of scale and scope are reflected in such affiliate's costs and are ultimately transferred to ratepayers through transactions with the carrier for such services valued at fully distributed costs. Requiring carriers to perform fair market valuations for such transactions would increase the cost to ratepayers while providing limited benefit."[48]

The FCC staff has interpreted the "exists solely" language in the above paragraph very literally. In other words, if an affiliate has but one sales transaction with a third party, then the exemption provided for in paragraph 148 would not apply. In that case, the lower of FDC or FMV valuation standard would apply to all products and services provided to the regulated carrier by that nonregulated affiliate. This literal interpretation is truly burdensome and costly. A nonregulated affiliate may provide many services to its corporate affiliates where economies of scale and scope are realized - however, that same affiliate may provide incidental or non-related services to third parties. For example, a nonregulated affiliate may provide procurement services only to corporate affiliates but may, in order to minimize its overall costs (thus benefiting the overall corporation), lease excess space in its facilities to third parties. In this instance, the existence of third party rental revenues should not "taint" the procurement services that are provided solely to affiliates and such procurement services should be valued at FDC without regard to FMV. We recommend that the FMV exemption be extended in these instances to specific product/service lines offered only to affiliates.

Similarly, services provided by the regulated carrier to affiliates that exist solely to provide services within the affiliated group should also be exempt from the FMV valuation requirements, as such transactions are for the most part rebilled to the LECs by the service company as a component of their costs of providing centralized services to affiliates. Thus, any difference between FDC and FMV would be captured in the exempt affiliate's costs and rebilled to the LEC, thus eliminating the impact of the original FMV accounting.

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[48] Accounting Safeguards Order, ¶ 148.

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VII. FUTURE ROLE OF REGULATORY OVERSIGHT

Regulatory Oversight Role of the FCC and State Commissions

The role of the FCC and State regulators has evolved over the past ten years since the implementation of Part 32. In 1988, Federal and state regulators were focused on the regulation of dominant carrier rates, accounting practices, depreciation rates and methods, service quality and technical standards, universal service and lifeline assistance programs, and ensuring that other social obligations relevant to the telecommunications industry were satisfied. Commissions also regulated carrier market entry and exit. Rate regulation was based on traditional cost-based, rate of return methods supported by extremely detailed accounting data.

In 1998, the FCC and State regulators are responsible for all of the above as well as the implementation of the Telecommunications Act. State Commissions have primary responsibility for arbitrating interconnection agreements and prescribing the rates and performance responsibilities of subject carriers. The Telecommunications Act reflects certain accounting and non-accounting safeguards associated with the transition from a regulated to a competitive, deregulated marketplace. The Act does not require continuation of outdated forms of regulation and reporting but encourages the revisiting of such regulations in order to provide for an efficient transition to a competitive, deregulatory environment. Price cap regulation of dominant incumbent LECs is utilized in the majority of jurisdictions in the current environment, whereas traditional rate of return regulation is still the common method of regulating the rates of smaller carriers.

The primary oversight role with respect to accounting and reporting requirements currently rests, under authority delegated from time to time, with the Accounting Safeguards Division of the FCC Common Carrier Bureau ("CCB") and related divisions at the State Commission level. The changes recommended herein will undoubtedly have an impact on the role of the accounting and audit staffs of the FCC and state commissions.

The current responsibilities of the FCC's Accounting Safeguards Division include:

- Development of accounting and reporting processes to measure the impact of FCC pronouncements.
- Administration of the USOA, including related accounting and recordkeeping requirements.
- Conduct of field audits and investigations of carriers' financial and operating practices, procedures and records.
- Reporting and distribution of accounting, statistical, service quality and infrastructure information.
- Setting of LEC interstate depreciation rates.

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Within the Accounting Safeguards Division, the FCC Audits Branch is responsible for the identification of, in conjunction with other CCB divisions, requirements for field investigations and audits (recurring, periodic and one-time) in support of accounting and structural safeguards, cost allocations, affiliate transactions, service quality reporting program, and infrastructure development program. The Audits Branch develops an integrated audit program, conducts field audits and investigations, conducts joint audits with State Commissions in areas of common interest, and establishes auditing procedures to determine compliance with the FCC's policy decisions and new initiatives in the area of industry structure.

The Reporting Management and Analysis Branch ("RMAB") of the Accounting Safeguards Division has the following mission statement:

> RMAB's primary mission is twofold: First, to address significant LEC issues in a manner that ensures that carriers are compensated fairly for their investment, that decisions are pro-competitive in a deregulatory environment, that quality services are maintained and available at reasonable rates, and cooperation and coordination with State Commissions on matters of their concern. Second, to obtain from the LEC industry the necessary and accurate data that will assist the Commission staff in making informed decisions in its public policy making process and to make that data easily available to Commission staff, State Commissions and other consumer and industry groups. It is our goal that such data will facilitate meaningful quantitative analysis, particularly with respect to economic, financial, engineering, universal service and service quality issues.

<u>Impact of Changes in the Industry Environment on the Regulator's Oversight Role</u>

In the current environment, detailed compliance auditing must give way to selective auditing of traditional regulated operations on a focused basis. The emphasis should shift to activities which further the regulators' role of implementing the new pro-competitive, deregulated environment and contribute to the overall growth of the telecommunications marketplace. The shift to a competitive marketplace should be accompanied by a shift to a business-risk oriented audit approach with emphasis on implementation of new regulatory and legislative initiatives instead of historical audit procedures focused on regulatory accounting and recordkeeping practices.

The role of the regulator in a competitive environment should be different from that role in a regulated environment. Information considered non-sensitive in a regulated environment becomes proprietary in a competitive world. That is not to say there is no role for a regulator in a competitive world. However, the type of information or data requests should be tailored to fit the regulatory mission. The missions of the regulatory staffs should be synchronized with that of the Commission.

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The current roles and responsibilities of the branches within the Accounting Safeguards Division embrace the need to assist the Commission in carrying out its responsibilities. Our recommendations to streamline the Part 32 accounting and affiliate transaction rules and the recordkeeping related to BPRs and depreciation should reduce the level of information required to be reported on a periodic or annual basis. However, the current level of detailed data submissions and related accounting requirements seem inconsistent with the FCC's current regulatory role. In fact, many reporting requirements are only relevant in a cost-based rate regulated environment.

Rather than requiring the reporting of detailed information on a regular basis, information should be requested by the staffs only on an "as needed" basis. Assuming some level of FCC staff effort has been required to process, analyze, compile and file these regular submissions, this is a time consuming and costly exercise. Are these efforts truly consistent with the goals of present regulation and are they value-added? The flexibility of the staffs should improve as they can investigate specific issues or results through a data-request procedure as opposed to the current approach of requesting significant amounts of reporting, performing trend analysis on such reports and requiring explanation of account variations. Staffs should be able to devote more time to the issues that really matter to all interested parties.

As described above, one of the responsibilities of the staff is to collect accounting, statistical, service quality and infrastructure reports from carriers. The ARMIS reports are among the reports required. We do not disagree with this responsibility—only the level of detail at which such information is being requested and reported. Such information was previously used in the rate making process to determine the appropriateness of costs for inclusion in the revenue requirement. Comparison of similar cost levels among "like" carriers was a useful exercise in determining cost recovery. However, with the setting aside of revenues based on costs, such information is less relevant. If one carrier decides to incur a high level of costs on research and development, while another carrier decides to spend a high level of costs on marketing activities, and another decides not to expend costs in the area of customer service, that is their business. In a competitive market, customers will consider a variety of issues in selecting a product and, if a new product appeals to them or service levels are unacceptable, they will choose service from another competitor. Further, to the extent that the industry continues to become more competitive, the sensitivity of such information increases. If it is important for the accounting and audit staffs to obtain information on service levels to be able to provide a report to the Commission, they always have the option of requesting such information from the carriers.

In summary, in a changing telecommunications world, the role of the regulator should also change. Flexibility in the accounting and audits staffs work efforts is desirable. Rather than require communications companies to establish systems and processes to accumulate and report significant volumes of information to the FCC, the staffs should determine which information is required to achieve a specific objective, justify the request, and request only that information from the carriers. The needs will change from year to year depending on a number of factors, and carriers should be able to provide the requested information in a reasonable time frame.

State Regulators' Simplification Efforts

It is important that any revisions in the level of information requested from carriers by the FCC staff be coordinated with the State Commissions. If a "streamlined" ARMIS procedure is adopted by the FCC, changes in the carriers' reporting processes to be responsive to such streamlining would likely result. However, if State Commissions continue to require the reporting of ARMIS information at the current level, a layer of additional cost to the carrier would likely result. Instead of reducing the effort necessary to comply with regulatory oversight (in an increasingly competitive environment), more effort would be required. For this reason, coordination between the FCC and State Commissions is clearly necessary. Similar to the FCC, State Commissions should have to justify requests of carriers under competition. As the shift from cost-based rates increases, the sensitivity of cost information becomes less relevant to the regulators and such information becomes more sensitive to competitors.

The proposed changes herein should not pose an undue hardship on the State Commissions. The State Commissions already collect the majority of their accounting information using the Class B chart of accounts under Part 32. The majority of states (32 in total) have adopted price cap regulation without earnings sharing similar to the FCC. In fact, many states have already granted flexibility in the depreciation rate setting process and have streamlined regulatory reporting processes.

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VIII. OVERALL SUMMARY

The recommendations contained in this paper provide a forward-looking blueprint to guide the transition from regulation to competition.

The Part 32 rules do not reflect the existing regulatory and competitive paradigm and as such impose an unnecessary and costly constraint on the carriers subject to its requirements. Such requirements should be streamlined and/or eliminated in order to provide subject carriers the increased flexibility necessary in today's competitive environment and to move the LEC industry towards accounting and recordkeeping practices (GAAP) utilized by companies outside of the local exchange telecommunications industry.

The accounting rules embodied in Part 32 (in particular the level of accounting and recordkeeping specificity required) were developed principally to support rate of return regulation in the absence of competition. As all LEC Coalition members and many other large LECs have adopted price cap regulation without earnings sharing in the interstate jurisdiction (and in 32 state jurisdictions), and as increased competition is the overall goal of the Telecommunications Act, those accounting and recordkeeping requirements designed in support of traditional rate of return regulation are no longer necessary.

The USOA imposes significant recordkeeping requirements on subject carriers that carry with them significant costs of compliance. The benefits associated with continuing many of these requirements are either spent, as demonstrated in this paper, or unclear. Further, competitors to the LECs are not subject to the same USOA requirements but must comply with only GAAP. These "costs of regulation" are very real and must be considered in today's competitive environment.

We recommend that the Commission adopt the recommendations contained in this paper now with the long-term objective of allowing the Coalition LECs to fully adopt GAAP consistent with companies outside of the local exchange carrier industry. The short-term recommendations described in the preceding sections of this paper should be implemented immediately and provide the basis for the transition to full reliance on GAAP for accounting, recordkeeping and reporting purposes in the telecommunications industry.